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ECONOMIC TRENDS

ESTABLISHED PROGRAMS FINANCING

1. Introduction

Various issues of Economic Trends have discussed the importance of federal transfer payments to Prince Edward Island. One of the more important of the federal transfers takes the form of Established Program Financing (EPF). This transfer is intended for financial support of the "established" programs of health and post-secondary education. Cash payments to the Province under EPF are forecast to be $49.7 million in the 1985-86 fiscal year, which represents the second largest federal transfer to Prince Edward Island after the Equalization transfer (discussed in the March 1983 issue of Economic Trends).

Because of the importance of the EPF transfer to the Province, and because it is presently the subject of considerable controversy, this issue of Economic Trends is devoted to a description of the historical development of EPF. Its history has been marked by continuing controversy between the federal government and the provinces. This controversy was recently heightened by the announcement by the federal government in December 1985 to reduce EPF transfer payments to the provinces by $2 billion annually by 1990-91 from projected levels, as part of the effort to curb the large federal deficit.

2. History of the Development of Federal Support of Established Programs

Before EPF was instituted in 1977, there were several separate arrangements authorizing the federal government to share in the costs of the major social programs of health care and post-secondary education. Although these programs are constitutionally within provincial jurisdiction, the federal government had offered to share costs with the provincial governments to help in the development of a nationwide health insurance system and in view of the rapid expansion of Canadian post-secondary education enrollment and facilities in the 1950's and 1960's. The federal government was seeking a means to promote national objectives and consistency between provinces in these areas, and also to expand the programs to meet growing demand. The provinces accepted offers of financial support, although in some cases there were deep concerns over potential intrusion and

control by the federal government in areas of provincial jurisdiction.

Federal financial support of post-secondary education was the first of the established programs, and at first took the form of direct federal grants to universities in 1951, distributed on the basis of population. Because Quebec opposed the federal grants as an intrusion into provincial jurisdiction, that province accepted an opting-out provision, and beginning in 1960 received instead an abatement of corporation income tax. Essentially, the federal government reduced its tax rate by one per cent of taxable income and Quebec increased its rate by the same amount. Thus the first tax "transfer" was born. This practice has become an important element in the financing of established programs, as will be seen later on. The basic idea behind a tax transfer is that the taxpayer pays no more or no less tax in total, but transfers his tax payment from one level of government to another.

In 1967 the federal government implemented a new arrangement for the funding of post-secondary education which involved a procedure for federal and provincial sharing of the operating costs of post-secondary institutions. The federal government reduced its corporate income tax by one percentage point and personal income tax by four percentage points to allow all provinces to raise revenues by increasing their taxes by a corresponding amount. For the relatively poorer provinces, the value of the tax points transferred was equalized to the national average under the Equalization program in effect at the time. If the value of the tax transfer was not sufficient to pay 50 per cent of the institutional costs, an additional payment was made in cash, such that the total of cash and tax was equal to 50 per cent of institutional operating costs, or a minimum $15 per capita payment. The minimum per capita payment was escalated annually by the percentage national increase in current operating expenditures for post-secondary education institutions. Prince Edward Island was one of three provinces to receive the $15 per capita minimum payment in the first year because its institutions were small and transfers equal to 50 per cent of operating costs would have resulted in payments below the $15 per capita minimum.

A second established program is Hospital Insurance and Diagnostic Services, which began in 1958 when the provinces formally accepted a set of federal principles in return for joint-funding of a pre-paid, universal hospital insurance program to be administered by the provinces. Coverage was to extend to all in-patient services normally offered at a standard ward level in active treatment, convalescence, and chronic care hospitals. As well, coverage had to be universal, provided on uniform terms and conditions across the country, with fully portable benefits. The federal contribution to a province was made as cash on a

cost-sharing basis. It consisted of 25 per cent of the national average per capita cost of the insured services in a given year, plus 25 per cent of the province's per capita cost of insured services, multiplied by the provincial population in that year. This amount came to over 50 per cent of total shareable costs in Prince Edward Island where the provincial per capita costs were low compared to the national average. Prior to the federal legislation, a provincial hospital insurance plan did not exist in Prince Edward Island.

Another of the established federal support programs was for Medicare which commenced in 1968 after the provinces met the terms and conditions for funding outlined in the Medical Care Act of 1966. A medical care insurance program also did not exist in Prince Edward Island prior to the legislation. The Act covered all medically required services provided by general practitioners and specialists. The federal cash contribution paid to provinces was 50 per cent of the national average cost per capita, multiplied by the provincial population. In Prince Edward Island, where costs were again much less than the national average, the federal share of costs in the province was consistently over 60 per cent.

Before 1977, cost-sharing between governments was also provided to extended health care services under what is now the Canada Assistance Plan. The objective was to eliminate some of the inflexibility in the cost-sharing arrangements by providing some interim financing for new services such as nursing homes and other non-hospital health institutions. This would allow for greater availability of alternatives to higher cost services which were cost-shared. The financing of extended health care services required a commitment from the provinces to reduce the growth rate of high-cost services.

The insured health services of hospital insurance and medical care were each brought into being through the passage of an Act of the Parliament of Canada which authorized the federal government to specify the terms and conditions under which the cash was to be transferred. In contrast, neither conditions nor even a statement of national objectives were expressed for the transfers for post-secondary education programs. Consequently, the education grants were in fact largely unconditional transfers.

3. Concerns Over the Cost-Sharing Arrangements

Over time, federal and provincial governments became increasingly concerned about the cost-sharing arrangements. Not only did the wide variations between provinces in per capita payments appear inequitable, but from an efficiency viewpoint there was concern that the rigidities of the cost-sharing

arrangements were resulting in inappropriate allocations of resources. Resources were being overallocated to areas which were cost-shareable, and more economical and efficient alternatives, which were not eligible for cost-sharing, were not receiving sufficient funds from provincial coffers. As an example, a tendency resulted for provinces to under-allocate resources to certain low-cost alternatives to hospitalization, such as home care, simply because these options were not eligible for cost-sharing.

Although there was widespread recognition in the mid 1970's of the need for provincial governments to seek more efficient service delivery, the existing financial arrangements did not allow the provinces flexibility in the structuring of their expenditure priorities. The provinces felt their ability to provide social programs where they were most needed was impaired by the necessity to meet federal requirements for which expenditures were shareable.

Meanwhile, another weakness of the financial arrangements was perceived by the federal government in its lack of adequate control and ability to predict its expenditures. As the established programs were maturing through the highly inflationary period of the mid 1970's, the federal government became very concerned over the escalation of its share of the program costs under the open ended nature of the cost-sharing arrangements, and the difficulties this entailed for expenditure planning.

This concern eventually led to various federal restrictions and caps on the federal commitment to health and higher education, such as a 15 per cent annual ceiling on the growth of the total federal contribution for post-secondary education, announced in 1972. Growth ceilings on federal contributions were also announced for medical care in the June 1975 federal budget, set at 13.5 per cent for 1976-77 and 10.0 per cent for 1977-78, with further unspecified ceilings authorized to be applied in future years by Order-in-Council. These various restrictions and caps on the federal contributions resulted in uncertainty as to the longer term adequacy of federal support.

4. The 1977 EPF Arrangements

The federal government was restricted in its ability to impose ceilings on the growth rate of its expenditures for hospital insurance, as it had done for the transfers for post-secondary education and medical care. Consequently, the federal government announced in the June 1975 federal budget its intention to terminate the Hospital Insurance and Diagnostic Services Act in 1980. This federal action, along with all the other problems of cost-sharing, brought to a head the realization

on all sides that a new financing arrangement for the "established programs" was essential.

After much consideration and negotiation, a long-term block fund arrangement was felt by both levels of government to be the best compromise. In return for predictability and stability of payment flow, which would also be of benefit to the provincial governments, the federal government promised the provinces one block fund which would cover all of the established programs. The block fund would provide provincial governments with more autonomy in program design and delivery, and at the same time there would be a simplification of administrative procedures.

Under this new method of financing, defined under the Federal-Provincial Fiscal Arrangements Act, effective April 1,1977, the three separate programs - education, hospital insurance and medical care - were covered under one single formula (a separate provision was also made for extended health care). This financing arrangement came to be known as "Established Program Financing" (EPF). The compensation was to be paid in the form of a mixture of cash payments and a transfer of tax points from the federal to provincial governments.

The income tax transfer to the provinces for the established programs was composed of 12.5 personal income tax percentage points, and one point of corporate income tax. One additional personal income tax point was also provided by the federal government as compensation for the expiry of the Income Tax Revenue Guarantee program. The Revenue Guarantee was implemented in 1972 to safeguard provincial revenues against possible reductions resulting from the provinces' agreement to adopt federal income tax reforms introduced in that year. Subsequently, the scope of the guarantee was extended to cover certain other federal income tax changes which reduced provincial revenues. At the time of the EPF negotiations, the federal government was seeking to terminate the Revenue Guarantee. In exchange for its termination, they offered to transfer to the provinces one personal income tax point plus an equivalent amount of cash per year. The negotiated settlement was incorporated into EPF, bringing the total personal income tax transfer to 13.5 percentage points.

In addition to the tax transfers under EPF, a separate cash contribution was made to each province equal to 50 per cent of the national average per capita contributions for the three established programs in the base year 1975-76, plus $7.63 (the cash compensation for termination of the Revenue Guarantee equivalent to revenue from one personal income tax point), multiplied by the population of a province and escalated annually in relation with the growth in Canadian Gross National Product (a three year compound moving average) per capita.

The total cash contribution under EPF consisted of the basic cash contribution, derived in the manner just described, plus a transitional adjustment payment to a province if revenues from the extra tax points equalized to the national average were less than the amount received from the basic cash contribution. These transitional payments were designed to increase the contribution to provinces with relatively less ability to raise revenues from the transfer of income tax points. Furthermore, a levelling adjustment payment was applicable to a province which had been above or below the per capita average payments under the arrangements prior to 1977. Provinces which had been above the per capita average would be levelled down over five years to the national per capita average, by the appropriate reducing fraction, and provinces below the national per capita average would be levelled up in three years' time. Consequently, within five years, the basic cash payments would be equal-per-capita in all provinces.

The EPF provision for Extended Health Care Services included cash funding only which was intended for nursing homes, intermediate care, adult residential care, converted mental hospitals, home health care and certain ambulatory health care services. The provinces received $20 per capita in 1977-78 for Extended Health Care, which was escalated annually thereafter by the three-year average compound growth rate of Canadian GNP per capita.

All cash payments under the EPF formula were thus essentially escalated by the growth of GNP and population. This provided a steady and more predictable payment schedule for the federal government. For the provinces, revenues arising from the transfer of personal and corporate income tax points could be used according to provincial expenditure priority without any federal interference. Also, the block fund cash contribution to provinces was to be made by the Government of Canada without direct reference to either provincial health expenditures or provincial post-secondary grants. Provinces were free to allocate the cash received to the areas of health and post-secondary education in the proportions they felt most appropriate. The block fund was a welcome improvement to the provinces over the previous restrictive cost-sharing arrangements.

However, the federal role under EPF did not simply become that of financier. As in the previous cost-sharing period, the federal government felt that one of the conditions of supplying funds to the provinces was provision for continuing joint discussions relating to the development of national policies in the fields of health and post-secondary education. This principle was clearly identified by Prime Minister Trudeau when the EPF arrangements were first proposed to the provinces:

> The objectives which have guided the Government in drawing up the Proposal (include)... to provide for continuing joint policy discussions relating to the health and post-secondary education fields. (First Ministers' Conference, June 1976).

Also, certain broad conditions which applied to federal contributions to health in the cost-sharing period continued to apply: accessibility, universality, portability, comprehensiveness and public administration.

In the final drafting stages of the federal legislation for the new financial arrangements, the value of the EPF cash entitlements was identified as being 67.9 per cent for health and 32.1 per cent for post-secondary education, based upon the division of provincial expenditures in Canada in 1976-77, as estimated by the federal government. Although EPF was set up as a block fund, this allocation was made for supposedly administrative purposes because the federal Department of Finance wished to allocate a portion of the cash transfer to the Minister of Health and Welfare and a portion to the Secretary of State for appropriate remittance to provincial governments. The actual division of spending between health and post-secondary education was quite different from province to province (and it has changed over the years, with increasing shares going to Health). If it was known at the time the problems this allocation would eventually cause for federal-provincial relations, perhaps other steps might have been taken!

Most provincial governments did not accept the basis on which the federal government segregated the cash transfer into program components. Also, the flexibility on the part of the provinces to move funding between program areas in accord with local priorities and needs was seen by them as a major benefit when block-funding was introduced. Therefore, most provinces viewed the division of the block fund as only a federal administrative procedure, and placed the revenues received from the Secretary of State and the Minister of Health and Welfare into general provincial revenues, without any such segregation. Thus, initially the arbitrary allocation between health and education did not bear much significance. Under the new arrangements the EPF payments were considered by provinces as an unconditional block fund.

5. Post 1977 History: Turmoil and Trouble

In the years following the 1977 arrangements the federal government became increasingly concerned with the unconditionality of the EPF transfers to the provinces. From the federal perspective, their desire to influence the provision of health services and post-secondary education was thwarted after

1977, as there was little the federal government could do to exert their influence in these areas given the manner in which the 1977 arrangements had been set-up. Consequently, the federal government undertook unilateral action in the first half of the 1980's to modify the original EPF arrangements to reduce some of the unconditionality of the transfers and to formalize greater federal control in the fields of health and post-secondary education.

Federal proposals to change EPF first surfaced in the November 1981 federal budget. Specifically, the federal government proposed that the Revenue Guarantee component of EPF be eliminated as of April 1, 1982, because the guarantee had no direct bearing on federal funding for the major social programs. The federal government also proposed that national standards for health be clarified, and an effective enforcement mechanism introduced. The Canada Health Act was subsequently passed by the federal government in 1984 which set out expanded program criteria for payment of the cash contribution for insured health services, and which required dollar for dollar deductions from transfers to provinces where they permitted extra-billing and hospital user charges.

To provide legislative support for more federal influence on the education side, the November 1981 federal budget proposed that new federal-provincial financing arrangements for health and post-secondary education be devised by March 31, 1983, in consultation with the provinces. The federal government threatened to freeze cash transfers at the 1982-83 level if negotiations on the new arrangements were not successful.

The federal view stated in the budget was that while the unconditionality of transfers for education was not an important issue in earlier times when the main priority of both orders of government was the expansion, improvement and greater accessibility of a national system of post-secondary educational institutions, circumstances had changed and the priority was now on better co-ordination of higher education and related activities. Although regional concerns remained important, long-term planning for the country as a whole had become vital. The federal government claimed that while recognition of these emerging needs led to the inclusion of a provision in the 1977 Fiscal Arrangements Act for joint federal-provincial policy discussions on the future direction of post-secondary education, the provinces had refused to engage in such discussions in the years since then. Therefore, a reassessment of the federal role and its financial support was required.

These proposals of the November 1981 federal budget, intended primarily to formalize greater federal control in the fields of health and post-secondary education, would require the formal splitting of the block fund into separate health and

post-secondary education components. The provinces were very much opposed to the proposal, as they tended to view the proper role of the federal government as one of a major funder only. The provinces wanted to receive federal funding with as few strings attached as possible. A provincial consensus document prepared in December 1981 rejected the federal proposals on the basis that they were a clear breach of faith. It called for a continuation of existing arrangements, because long-term stability and a block fund were the basic principles behind the creation of the EPF arrangements in 1977. The freeze on growth in spending threatened by the federal government did not materialize.

On April 1, 1982, the first date possible for unilateral amendments by the federal government, the federal government introduced two fundamental amendments to the EPF funding formula - the first of many changes to come. First, compensation for the Revenue Guarantee program was discontinued, as was proposed in the November 1981 budget, despite intense provincial opposition. The termination was accomplished by reducing the base year per capita cash entitlement under EPF by double the value of the cash component of the Revenue Guarantee.

Second, to increase interprovincial equity, EPF entitlements were amended to be equal per capita across provinces. Previously, provinces whose equalized tax revenues under EPF were less than their basic cash contribution, received a transitional cash payment equal to the difference between the equalized tax point revenue and the basic cash transfer. The result of the transitional payment was to ensure that the per capita tax and cash entitlements for any province would be equal to at least twice the value of the cash payment. However, in cases where the tax point revenue for a province exceeded the basic cash payment, that province retained the excess, with the result that its per capita EPF entitlement exceeded that of the other provinces.

The amendment to make EPF entitlements equal-per-capita across provinces effectively eliminated this "fiscal dividend" which was accruing to provinces such as Alberta. Equal-per-capita entitlements were accomplished by calculating a <u>total</u> EPF per capita entitlement for all provinces, from the base entitlement for 1975-76, inflated annually by the GNP escalator. The cash transfer to a province was then derived as simply the residual element, after the equalized tax transfer for that province was accounted for. Therefore, provinces previously receiving the fiscal dividend would now receive a smaller cash contribution than they would have received under the previous formula.

This is how EPF funding is currently determined. Charts 1 and 2 are diagramatic presentations provided by Federal Finance of the components of the total provincial entitlements forecast

Chart 1

How EPF Post-Secondary Education Contributions Are Determined 1985-86
(Dollars Per Capita)

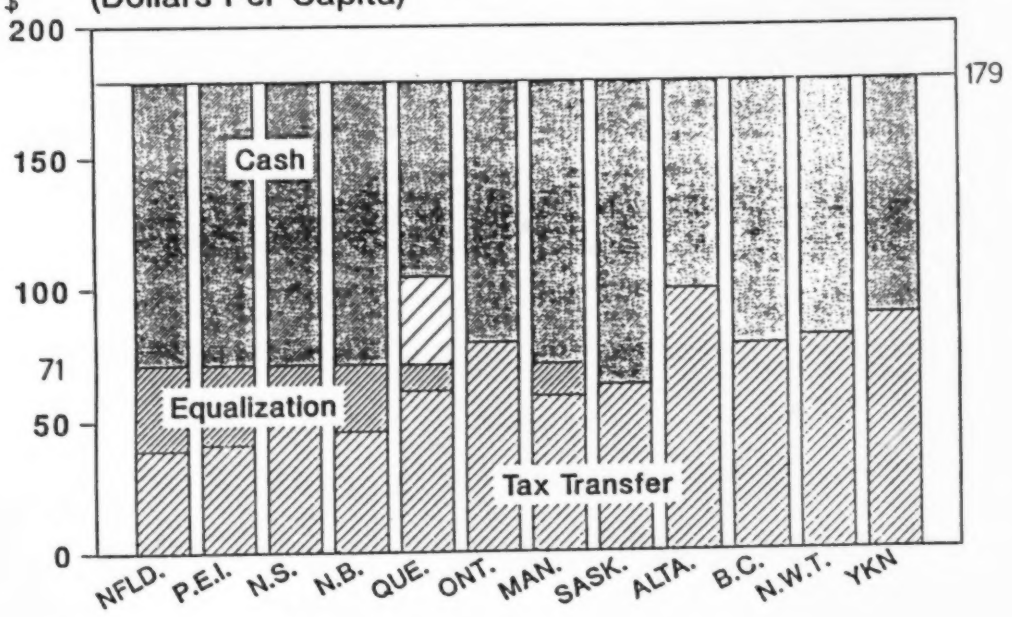
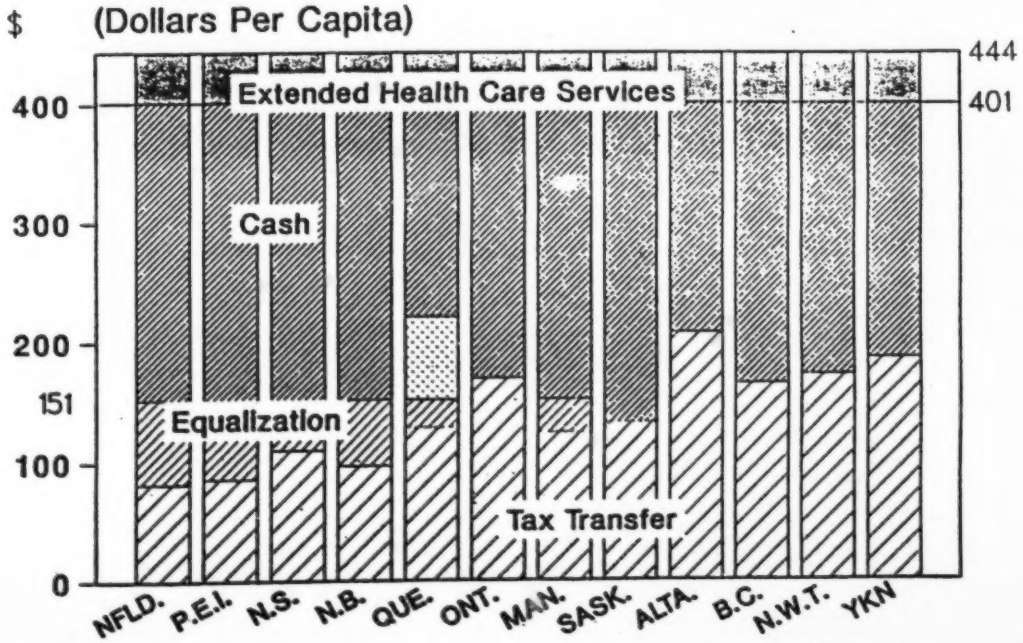


Chart 2

How EPF Health Contributions Are Determined 1985-86
(Dollars Per Capita)



for 1985-86, for post-secondary education and health respectively. The Charts identify the cash entitlements, the value of tax points, and the value of equalization from these tax points, on a per capita basis. As one can see, the cash contribution, per capita, varies from province to province depending on fiscal circumstances (the value of the tax transfer to them). The division of the transfers between Health and Post-Secondary Education is in accordance with the federal division.

In December 1982, nine months after the announcement of the Revenue Guarantee termination and equal per capita entitlements across provinces, Mr. Lalonde stated at the Annual meeting of Ministers of Finance and Treasurers the federal government's intention to carry through with the earlier proposal to split the EPF block fund into health and post-secondary education components. This was followed by a public announcement in March 1983 of the division of the block fund (formalized by Bill C-12 in 1984). The amendment to EPF formally divided the tax as well as the cash transfer between the two programs.

The stated federal perspective was that the EPF fiscal transfers were intended to be spent on health and post-secondary education in the proportions identified in the federal legislation (which were 67.9 per cent for health and 32.1 per cent for post-secondary education). The new legislation required the Secretary of State to report to Parliament annually on the extent of cash and tax contributions, by province, made by the federal government for post-secondary education goals, and the corresponding expenditures by each province. The Secretary of State was also to report on the results of any of its consultations with the Canadian Council of Ministers of Education relating to the definition of national purposes to be served by post-secondary education and the means by which the government of Canada and the provinces would achieve those purposes.

Also announced in March 1983 was the application of the "6 and 5" restraint program on the post-secondary education portion of the EPF contribution. Growth of the tax and cash transfers per capita for post-secondary education was restricted to 6 and 5 per cent during 1983-84 and 1984-85, respectively, instead of rising with GNP. Although the restraint measure was applied to the total entitlement, the value of the revenue reduction was passed on through a reduction in the federal cash transfer. Having vacated the EPF tax room in 1977, the federal government was unable to restrict the revenue generated by the tax points as they were now levied by the provinces and hence outside of federal jurisdiction and control. As a result, the proportion of the cash payments for post-secondary education decreased from 28 per cent of total EPF cash entitlements to 26 per cent.

The provinces were very much opposed to these federal actions. They asserted that the federal splitting of EPF from the beginning was unjustified, and also that the allocation to health and education components had no relationship to actual provincial spending. Some provinces felt that the federal government was now using the artificial allocation of the EPF block fund to justify efforts to reduce financial support for health and higher education. In particular, the allocation of payments under EPF to post-secondary education for provinces such as Prince Edward Island tends to overstate the federal contribution to post-secondary education, thereby making it a target for reduced financial support. The problem is heightened by a lack of data on exactly what monies are allocated to what programs under EPF. The problem of determining how much of the federal transfers are contributing to provincial programs has not been resolved even to this day.

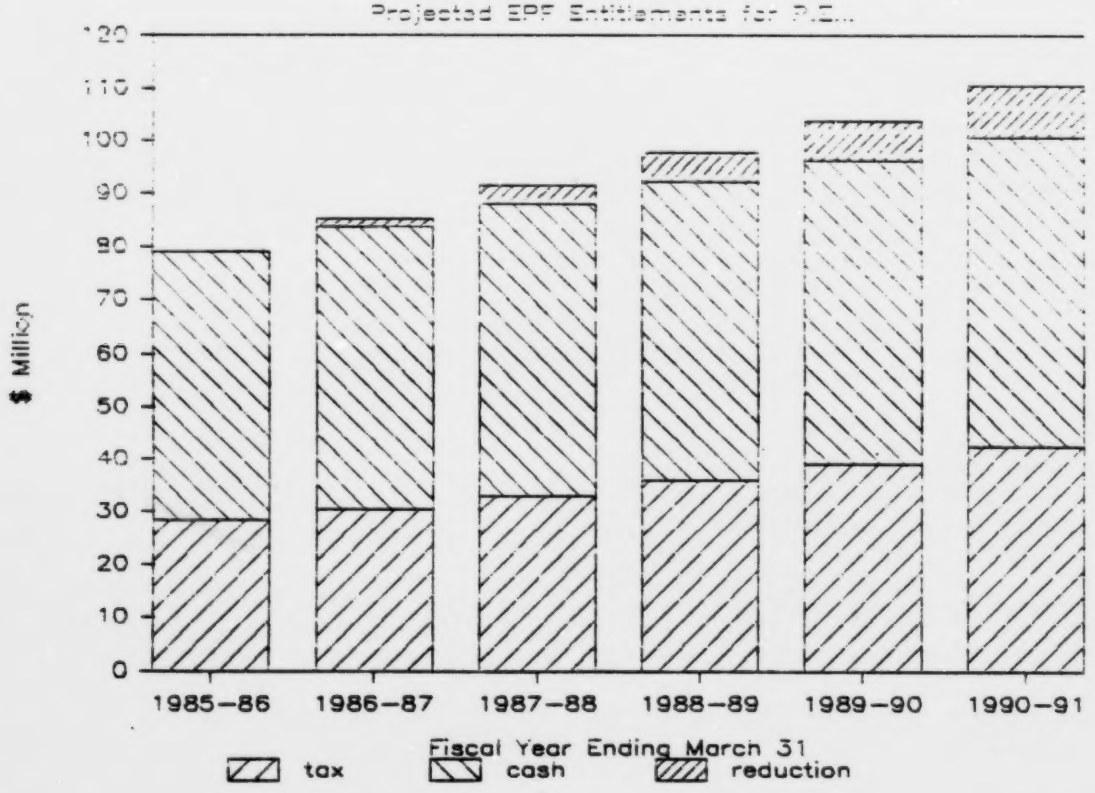
For 1982-83, the latest fiscal year for which final data is available, Prince Edward Island received $37.4 million in cash and $24.4 million in provincial tax revenues allocated by the federal government under EPF, for a total "entitlement" of $61.8 million. For the reasons given previously, the question of the division of the $61.8 million to Post-Secondary Education and to Health remains open. Nonetheless, of the total EPF entitlement for Prince Edward Island, the federal government identified $43.3 million as the federal transfer for health (including extended health care services), and $18.5 million for post-secondary education. According to Statistics Canada, gross-provincial expenditure for health services in general was $85.0 million in Prince Edward Island in 1982-83, while that for post-secondary education totalled $21.4 million, as reported in Provincial Government Finance (catalogue 68-207). Thus, total provincial spending in these areas was $106.4 million.

6. The EPF Program Today

The EPF program has clearly not provided the stable, secure, source of funds that was the intention at its inception. Furthermore, where provinces have attempted to restrain spending in the health and post-secondary education areas they have been accused of misapplying federal transfers. The general atmosphere with respect to EPF could be described as confusing, clouded and mistrusting. There is no longer a clear definition of precisely which programs are supported by EPF, a common understanding of how federal monies are to be divided among the programs, nor any common agreement on the allocation of tax transfers specified under EPF. As far as provinces are concerned, the value of the taxes collected from the "tax point transfer" are to be disposed of entirely at the discretion of provinces, and the cash received under EPF is essentially unconditional.

Provinces are concerned however over the overall adequacy of federal funding in light of the evergrowing demands for improved health services and improved access to post-secondary education. The reduction in growth of EPF transfers by $2 billion by 1990-91 has heightened these concerns. EPF cash payments to the provinces will be reduced significantly from projected levels, beginning in the 1986-87 fiscal year, as the growth rate of the total contribution is set 2 percentage points below the GNP escalator. Chart 3 shows EPF entitlements (tax and cash) for Prince Edward Island, as projected by Federal Finance for the years 1985-86 to 1990-91, showing the impact of the announced reduction. By 1990-91, the annual reduction in the EPF entitlement to Prince Edward Island from previously forecasted levels is projected to be approximately $10 million. As the tax point transfer is not affected the reduction will come from the cash transfer. This was projected to have been $68.1 million in 1990-91 and will now be $58.1 million. This compares with a cash transfer entitlement of $50.6 million in 1985-86.

Chart 3



Thus, the EPF program remains controversial at this time. It is unfortunate that the delivery of such important public services as health care and higher education should be subject to such disputed funding arrangements as the EPF programs have been and appear to remain. The resolution of the controversy is of particular importance to Prince Edward Island, with the EPF cash transfers currently accounting for about eleven per cent of the total revenues available to the provincial government. It is hoped that this paper will contribute to a better understanding of EPF and the issues at hand through a description of the historical events which have shaped the existing EPF arrangements.

January 24, 1986